Presentation to Senate Education Committee on MPSERS

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Michigan Public School Employees' Retirement System (MPSERS)

- Structure
- Current Unfunded Liabilities and Funded Ratios
- Recent Reforms

Until Public Act 75 of 2010, the entire MPSERS system was a Defined Benefit Plan.

<u>What is a Defined Benefit Plan?</u>

A defined benefit (DB) plan is one that offers a fixed, continuous stream of income after a person retires, often referred to as a "pension". An employee in a DB plan must work for a set period of years before becoming eligible to receive a pension upon retirement ("vesting"), and must work either a certain number of years or to a certain age, or both, in order to receive full pension benefits. Working fewer than the required number of years, or leaving employment before reaching a certain age (but after vesting) results in a permanent reduction to the maximum amount of pension allowance.

A person's pension depends on the years of service and final average compensation (FAC). The multiplier is 1.5% under current law. The FAC is the average of the three-year period yielding the highest total wages for MIP members, and the average of the five-year period yielding the highest total wages for Basic and Pension Plus members.

- Under current law, Pension = Years of Service X FAC X 1.5%.
- For example, a person with 30 years of service and FAC of $70,000 would earn, under current law, a pension of $31,500 per year.

However, Public Act 75 of 2010 included a Defined Contribution component, and was termed a "hybrid" plan, that now is called "Pension Plus".

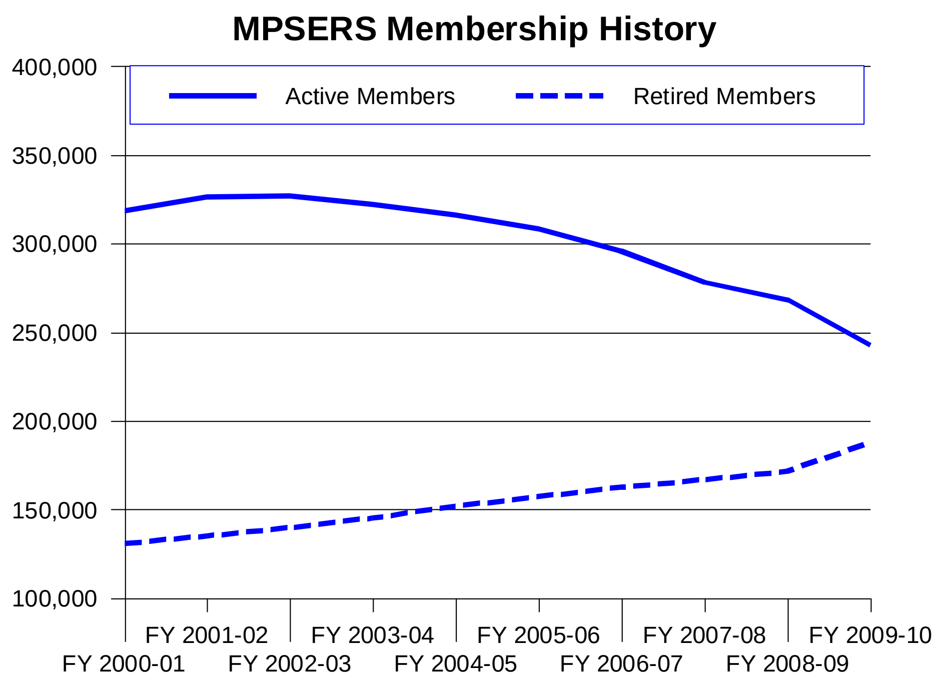
<u>What is a Defined Contribution Plan?</u>

A defined contribution plan is one in which contributions are made to a retirement account, by either the employer or the employee, or both. The amount a person receives when he or she retires depends on the level of contributions made over the employee's lifetime and the investment returns on those contributions. A DC plan does not provide a fixed, continuous stream of retirement income, but instead provides a retirement account with a variable value that usually relies on market and investment performance. State (not school) employees hired after March 31, 1997, are now part of a DC plan. School employees hired after July 1, 2010, have a DC component to their retirement, discussed below.

Basic MPSERS System Information

In 2010, there were 242,568 active (working) members and 187,722 retired members of MPSERS. Pensions totaling $3.5 billion were paid to retirees in 2010. Also, health care for retirees was provided, at a cost of $650.7 million. The system includes all 552 K-12 districts, 59 public school academies (charter schools), seven universities (for employees hired before January 1, 1996), all 28 community colleges, all 57 intermediate school districts (ISDs), and 11 libraries.

Figure 1



Source: Office of Retirement Services - Comprehensive Annual Financial Reports

How is the System Funded? Employee and Employer Contributions

Employee Contributions

It is critical to note that MPSERS is a plan that requires contributions from employees, as well as from employers, in order to have funds available to pay out the earned pensions and health benefits. See Table 1, for a summary of the different plans within MPSERS, based on hire date.

Table 1

Date Hired	Type of MPSERS Plan	Employee Contribution	Age Eligibility	Health Care
Before 1/1/90	Basic	$0	Age 55 w/30 years Or Age 60 w/10 years	90% State Premium Coverage, 10% Employee Payment – coverage begins upon retirement
Between 1/1/90 and 6/30/2008	MIP (Member Investment Plan)	$510 plus 4.3% of salary above $15,000	Any age w/ 30 years Or Age 60 w/10 years OR Age 60 w/five years under certain circumstances	90% State Premium Coverage, 10% Employee Payment – coverage begins upon retirement
Between 7/1/08 and 6/30/2010	MIP (Member Investment Plan)	$510 plus 6.4% of salary above $15,000	Any age w/30 years Or Age 60 w/10 years	Graded health care premium – earn 30% for first 10 years of service, plus 4% State coverage for each year of service after that, up to a maximum of 90% coverage with 25 years of service. Also, retirees must have 25 years of service to draw health benefits, or, if they have less than 25 years, be at least age 60.
After 7/1/10	Pension Plus – a scaled back DB pension and a DC	$510 plus 6.4% of salary above $15,000 to support the DB; also, 2.0% to support DC (unless opting out). Another 3.0% of salary is paid to support retiree health care.	Must be at least age 60 to draw the DB pension benefits; can retire earlier, but can use DC contributions and earnings until reaching age 60 and drawing monthly pension payments.	Graded health care formula in effect; however, the maximum State coverage will equal the amount State employees receive (currently 80% State coverage for people who hired in after 4/1/10). If this percentage stays in effect, the maximum State coverage would be 80% of premium, and retirees would pay 20% of the premium cost.

Employer Contribution Rates

Each year, the Office of Retirement Services publishes the upcoming fiscal year's retirement "rate", and employers (e.g., school districts, ISDs, community colleges, etc.) remit to the State that published MPSERS rate applied to their payroll. The rate is made up of three components: a "normal" cost, the unfunded accrued liability (UAL) cost, and the health care cost.

- Normal

Due to the significant employee contributions required under MPSERS, the "normal" cost of funding the MPSERS DB pension is very low. At the present time, the normal cost for employees hired before July 1, 2010 is 3.74% of payroll, and for those hired after, it's 2.24%. For comparison purposes, the "normal" cost of the State's DC plan (for State employees hired after March 31, 1997) is 6.00%.

- UAL

The unfunded accrued liability represents the difference between assumed returns on investments and payouts and the actual returns on investments and payouts. The plan's investment managers assume an average 8% annual return on investments over the long term, although in any given year the return may be greater or less than that amount. In the early part of the decade, as stocks lost value, the system was left with much less revenue than was expected. Because employer contribution rates are calculated based on the plan's assets as well as its projected costs, those contribution rates have had to increase to compensate for the poor investment performance. The current rate to pay for the UAL is 8.42% of entire payroll. There is no unfunded accrued liability in a DC plan because any investment losses are borne by the employee in his or her portfolio.

- Health

Until PA 75 of 2010, the health care piece of the retirement contribution rate represented the actual cost of paying for this year's retiree health care costs and dividing by the payroll of active members (cash basis, rather than prefunding). However, with the changes in PA 75, active employees are required to contribute 3% of salary to support retiree health, and, in the absence of the lawsuit on this item, employers would pay the rest. Since the 3% contributions from employees are in an escrow account per court order, employers are continuing to pay the entire health care rate. For the current year, employers are paying 7.25% of payroll toward retiree health. (This is separate from, and in addition to, payments for active employees' health care, which is negotiated at the local level.) If the court case is found in favor of the State, employer costs for retiree health will be reduced by 3% of payroll, to 4.25% in the current year.

Table 2 tracks the historical MPSERS employer contribution rates from fiscal year 2000-01 through 2009-10. Table 3 shows how two separate rates are now calculated, one for the Basic and MIP members, and the other for the portion of payroll that includes Pension Plus members.

Table 2

MICHIGAN PUBLIC SCHOOL EMPLOYEES RETIREMENT SYSTEM
MEMBERS, WAGES, AND EMPLOYER CONTRIBUTION DATA FY 2000-01 to FY 2009-10
(Dollars in Thousands)

Defined Benefit	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**	**2006-07**	**2007-08**	**2008-09**	**2009-10**
Employer Contribution Rates										
Pension Normal Rate	6.42%	6.06%	6.26%	6.26%	6.31%	5.47%	5.49%	5.28%	5.17%	3.98%
Pension UAAL Rate	0.19%	0.06%	0.68%	0.68%	2.01%	4.32%	5.70%	4.89%	4.56%	6.15%
Health Rate	5.55%	6.05%	6.05%	6.05%	6.55%	6.55%	6.55%	6.55%	6.81%	6.81%
Total Rate	**12.16%**	**12.17%**	**12.99%**	**12.99%**	**14.87%**	**16.34%**	**17.74%**	**16.72%**	**16.54%**	**16.94%**
Wages (DB)	$9,264,183	$9,707,281	$10,043,862	$10,407,072	$10,205,972	$9,806,452	$9,851,471	$9,958,132	$9,883,674	$9,913,615
Employer Contributions										
Pension Contribution	$612,362	$594,086	$697,044	$722,251	$849,137	$960,052	$1,102,380	$1,012,742	$961,681	$1,001,252
Health Contribution	$514,162	$587,291	$607,654	$633,439	$668,491	$642,323	$645,271	$652,258	$673,078	$675,117
Total Contribution	**$1,126,524**	**$1,181,377**	**$1,304,698**	**$1,355,690**	**$1,517,628**	**$1,602,375**	**$1,747,651**	**$1,665,000**	**$1,634,759**	**$1,676,369**

Note: Does not include employee contributions.
Source: Office of Retirement Services – Comprehensive Annual Financial Reports

Table 3

MPSERS RETIREMENT RATES FOR FY 2011-12 AND FY 2012-13

	FY 2011-Rev 10/1/10		**FY 2011-12**		**FY 2012-13**	
	Employed Prior to 7/1/2010	**Employed After 7/1/2010**	**Employed Prior to 7/1/2010**	**Employed After 7/1/2010**	**Employed Prior to 7/1/2010**	**Employed After 7/1/2010**
Pension Normal Cost	3.74%	2.24%	3.47%	2.24%	3.47%	2.24%
Pension Unfunded Accrued Liability (UAL)	8.42	8.42	12.49	12.49	12.49	12.49
Retirement Incentive (Five-Year Payback)					2.66	2.66
Pension Total Retreat	**12.16%**	**10.66%**	**15.96%**	**14.73%**	**18.62%**	**17.39%**
Retiree Health (Cash Basis)	5.50	5.50	5.50	5.50	5.75	5.75
Surcharge due to Injunction	3.00	3.00	3.00	3.00	3.00	3.00
Health Care Total Rate	**8.50%**	**9.50%**	**8.50%**	**8.50%**	**8.75%**	**8.75%**
Total Rate	**20.66%**	**19.16%**	**24.46%**	**23.23%**	**27.37%**	**26.14%**
Rate Increase			**3.80%**	**4.07%**	**2.91%**	**2.91%**

Source: State Budget Office

Assets and Liabilities

As of September 30, 2010, net system assets were $42.1 billion; the Department of Treasury invests these assets. In 2010, the pension system was 78.9% funded. This means that, at the present time, the total value of all earned benefits (to be paid out over the lifetimes of retirees) exceeds the amount of assets in the system. When assets equal all earned benefits, a system is 100% funded. The variable that has the most impact on a system's funded ratio is the performance of the stock market.

Public Acts 75 and 185 of 2010 represented an initial effort by the Legislature to prefund retirement health benefits for State and public school employees. Pursuant to these Acts, MPSERS and SERS members are now required to contribute a portion of their total compensation for deposit in a retirement health care fund. While these employee contributions will not eliminate the long-term unfunded liabilities in the MPSERS and SERS, they constitute a first step toward safeguarding future benefits by establishing a mechanism to allow for prefunding.

Tables 4 and 5 indicate not only the MPSERS unfunded liabilities and funded ratios, but also show the other retirement systems overseen by the State. Over the past decade, as seen in Table 4, the MPSERS funded ratio has declined from nearly 100% fully funded to 78.9% funded, with liabilities in the pension system totaling nearly $12.0 billion. These liabilities, as discussed earlier, are paid for by assessing a UAL contribution, and the financing of the shortfall is amortized over a 30-year period.

Table 5 illustrates the unfunded liabilities in the health system. For MPSERS, since there is very little prefunding and the benefits are paid on a cash basis, the funded ratio is 2.5%. Liabilities, measured by the difference between assets on hand today and the promised health benefits, total an estimated $27.6 billion.

Table 4

TOTAL ACCUMULATED PENSION UNFUNDED LIABILITIES										
	MPSERS		SERS		STATE POLICE		JUDGES		LEGISLATIVE	
Fiscal Year	Unfunded Liability	Funded Ratio	Unfunded Liability	Funded Ratio	Unfunded Liability	Funded Ratio	Unfunded Liability	Funded Ratio	Unfunded Liability	Funded Ratio
1999-2000	$246,000,000	99.3%	($863,000,000)	109.1%	($72,400,000)	107.0%	($70,600,000)	134.6%	($31,782,000)	125.0%
2000-01	$1,375,000,000	96.5%	($755,000,000)	107.6%	($75,000,000)	107.0%	($66,300,000)	129.5%	($29,778,000)	121.0%
2001-02	$3,575,000,000	91.5%	$137,000,000	98.7%	($5,600,000)	100.5%	($62,500,000)	127.3%	($23,300,000)	116.0%
2002-03	$6,043,000,000	86.5%	$1,320,000,000	88.8%	$47,300,000	96.0%	($57,100,000)	124.3%	($17,519,000)	112.0%
2003-04	$7,533,000,000	83.7%	$1,855,000,000	84.5%	$138,100,000	89.0%	($50,500,000)	121.3%	($9,967,000)	107.0%
2004-05	$9,995,000,000	79.3%	$2,503,000,000	79.8%	$210,000,000	83.8%	($35,000,000)	114.4%	($2,806,000)	102.0%
2005-06	$6,141,000,000	87.5%	$1,909,000,000	85.1%	$181,700,000	86.9%	($39,100,000)	116.0%	($940,000)	101.0%
2006-07	$5,771,000,000	88.7%	$1,818,000,000	86.2%	$192,700,000	86.7%	($53,900,000)	121.8%	($4,437,000)	103.0%
2007-08	$8,931,000,000	83.6%	$2,363,000,000	82.8%	$230,600,000	84.6%	($56,700,000)	123.0%	($590,000)	100.0%
2008-09	$11,982,000,000	78.9%	$3,127,000,000	78.0%	$295,900,000	80.7%	($50,700,000)	120.7%	$5,631,000	97.0%
FY 2008-09 Total Accrued Unfunded Liability for the five retirement systems equals $15,359,800,000.										
Note: Negative numbers in the unfunded liability column represent surplus assets in a retirement system.										

Table 5

TOTAL ACCUMULATED HEALTH UNFUNDED LIABILITIES										
	MPSERS		SERS		STATE POLICE		JUDGES		LEGISLATIVE	
Fiscal Year	Unfunded Liability	Funded Ratio	Unfunded Liability	Funded Ratio	Unfunded Liability	Funded Ratio	Unfunded Liability	Funded Ratio	Unfunded Liability	Funded Ratio
2005-06	$24,757,000,000	2.5%	$13,499,000,000	0.0%	$944,400,000	0.0%	$6,400,000	0.0%		
2006-07	$24,957,000,000	3.0%	$12,966,000,000	0.0%	$918,100,000	0.0%	$6,600,000	0.0%		
2007-08	$25,979,000,000	3.1%	$13,542,000,000	0.0%	$963,000,000	0.0%	$6,700,000	0.0%	$118,309,000	11.0%
2008-09	$27,582,000,000	2.5%	$12,618,000,000	0.0%	$882,300,000	0.0%	$6,600,000	0.0%	$122,282,000	11.0%
FY 2008-09 Total Accrued Unfunded Liability for the five retirement systems equals $41,211,200,000.										

Recent Reforms

2007: Senate Bills 546 and 547 of 2007 (Public Acts 110 and 111)

Senate Bill 546 primarily implemented a graded health care premium based on years of service for school employees (State employees hired after March 31, 1997 have a graded premium). Senate Bill 547 increased by 50% the amount an employee must pay into the MPSERS to support their pension benefits. The changes in the bills are summarized below:

Senate Bill 546 of 2007 amended the Public School Employees Retirement Act to require MPSERS to pay the following for a member who joins the system after June 30, 2008:

- For a retirant who is at least 60 years old at the time of application for benefits and has 25 years of service credit under the Act, 90% of health insurance premiums.
- For a retirant who is less than 60 at the time of application for benefits, who has at least 25 years of service credit excluding purchased service credit, 90% of health insurance premiums.
- For a retirant who is at least 60 at the time of application for benefits, who has at least 10 but less than 25 years of service credit, a percentage of health insurance premiums equal to 30% for the first 10 years of service plus 4% for each additional year of service beyond 10 years.

The bill also does the following:

- Provides that a member who purchases service credit after June 30, 2008, is not eligible for health premium payments until he or she would have been eligible to retire without purchasing service credit. Prohibits MPSERS from paying retirement health benefits to a member unless he or she earned at least half a year of service credit during the two school fiscal years immediately preceding his or her retirement, or at least 1/10 of a year of service credit during each of the previous five school fiscal years.

Senate Bill 547 of 2007 amended the Public School Employees Retirement Act to do the following:

- Require a person who first becomes a member of MPSERS on or after July 1, 2008, to contribute to the Member Investment Plan 6.4% (rather than 4.3%) of income above $15,000.
- Require a member, beginning July 1, 2008, to complete at least two years of service before purchasing service credit.

Fiscal Impact

Senate Bill 546

The bill will have a small fiscal impact on the State. The Office of Retirement Services (ORS) already administers MPSERS, but might need to increase staff or responsibilities associated with implementing the changes in this bill.

Under the bill's graded premium program provision, local districts eventually will see significant savings due to lower MPSERS contribution rates for retiree health benefits. However, there will be no savings in the first 10 years of the program. Savings gradually will increase over the course of 30 to 40 years, when all retirees will be covered under the graded premium program.

The provision in this bill that places an age requirement on the receipt of health care benefits, unless a retiree has 25 years of service, also will produce savings for districts in the long term. There will be no savings in the first 10 years of the program, since the earliest any newly hired employee can retire with benefits will be after 10 years of service when he or she is at least 60 years old. After 10 years, there will be gradually increasing savings for the next 20 to 25 years. Like the graded premium program, full savings will not be realized for 30 to 40 years, when all retirees fall under the plan and subsequently retire.

The ORS estimates that in the long term (40 years), combined savings from the graded health care and age requirement will total around 45%. To put this in perspective, if these provisions had been in place the past 40 years, then public school employee retiree health care costs in FY 2004-05 would have been $418 million rather than the $760 million actually paid out.

Finally, ORS estimates that the provision prohibiting a retiree to draw down health care benefits during the time of retirement attributable to purchased service credit will save approximately $45.4 million per year. This will apply to current and future employees who purchase service credit on or after July 1, 2008.

Senate Bill 547

The bill may have a small fiscal impact on the State. The ORS might need to increase staff or responsibilities associated with implementing the changes in this bill.

Increasing the member contribution rate from 4.3% of salary over $15,000 to 6.4% will produce savings for reporting units of MPSERS. The member contributions are credited against what a district owes to MPSERS for the normal cost portion of the retirement rate. Therefore, increasing member contribution will decrease the amount required from the district. The ORS estimates savings of $5.0 million in the first year, growing to $29 million by the sixth year, and continuing to grow over 30 to 40 years until the entire workforce becomes subject to the increased contribution rate.

The provision in this bill requiring a member to have two years of service before being able to purchase service credit will generate savings of at least $5.7 million per year for local districts, as estimated by the ORS.

2010: Senate Bill 1227 of 2010 (Public Act 75)

Senate Bill 1227 included a retirement incentive (not discussed here) and introduced a hybrid retirement plan, consisting of both a DB and DC component. This is now termed "Pension Plus". The bill included 3% mandatory contributions for retiree health. The bill also eliminated a loophole for third-party contracting to "double dip".

-- Required contributions for retiree health

Public Act 75 requires all employees in MPSERS to contribute 3% of salary (in addition to the pre-existing pension contributions described in Table 1) into a funding account, defined as an appropriate irrevocable trust established under PA 77 of 2010 (House Bill 4073), on wages earned after July 1, 2010.

It is anticipated that the 3.0% employee contributions will save employers more than $300.0 million per year, or $3.5 billion over a 10-year period. These savings will be realized by a lower employer contribution rate than otherwise would have occurred in the absence of the employee contributions. However, at the present time, the judge presiding over a lawsuit in Ingham County Circuit Court has ordered that the employee contributions being remitted as of July 1, 2010, be placed in escrow until the lawsuit is resolved. Therefore, the Office of Retirement Services is continuing to charge MPSERS employers the full amount for retiree health, currently at 7.25% of payroll, until the lawsuit is resolved, at which time the actuary will again re-examine the system and determine if the rate should be adjusted, and in which direction.

In general terms, the lawsuit (*McMillan, et al.* vs. *MPSERS, et al.*) alleges that the new 3.0% employee contributions for retiree health care are a violation of the State's contract with the members of the Retirement System. Since there was no corresponding increase in benefits, the lawsuit alleges that the increased employee contributions impair or violate the State's contractual obligation to provide health care benefits as prescribed in the Retirement Act. If the lawsuit is decided in favor of the plaintiffs and the 3.0% employee contributions are disallowed, then there will be a net increase to schools to pay for the retirement incentive, since there will no longer be offsetting savings from employer contributions to pay for the incentive. If the lawsuit is decided in favor of the State, and the 3.0% employee contributions are allowed to be counted in FY 2010-11, the MPSERS employer contribution rate may fall somewhat below the 19.41% currently being charged.

-- Hybrid Plan for New Employees

Employees first hired on or after July 1, 2010, are placed in a new "hybrid" pension plan, with a blending of defined benefit (DB) and defined contribution (Tier 2) components. A person under this plan will not be able to receive pension payments until age 60, and will be required to have worked at least 10 years as a public school employee. The purchase of service credit by these employees is prohibited, and cost-of-living adjustments to the pension are not provided. An employee will have to contribute $510 annually plus 6.4% of salary above $15,000, in addition to the Tier 2 contributions described below.

An employee under this plan will have to contribute 2.0% of salary to his or her Tier 2 account, unless affirmatively electing not to contribute or to contribute a lesser amount. The employer will have to match 50% of the employee's first 2.0% of salary contribution, for a maximum total employer payment of 1.0% of salary deposited into the Tier 2 account. This is in addition to the employer cost for the DB pension of this employee. The employee will be allowed to contribute more than 2.0% of salary, but the employer will not match more than 1.0%, unless choosing to do so under a locally negotiated agreement. An employee described here is immediately vested in his or her own contributions, and will vest in employer contributions as follows: 25% after two years of service, 75% after three years of service, and 100% after four years of service.

The DB side of this hybrid plan will use a five-year period on which to calculate the final average compensation, likely generating a lower FAC than is in current law. (For Basic Plan members, the time frame is five years; for MIP members, the time frame is three years.) Also, under this plan, the actuary will be required to assume a 7.0% rate of return on the investments in the portfolio (rather than the 8.0% rate under current law). The actuary may determine a different employer contribution rate for these members.

Any entity receiving full or partial, direct or indirect funding from the School Aid Fund, and not participating in MPSERS, may opt into the hybrid retirement plan for its employees, upon approval by the Internal Revenue Service. In addition, existing MPSERS employees hired before July 1, 2010 (i.e., not part of the hybrid plan) may opt into the Tier 2 component of the hybrid plan without an employer match. Hybrid plan employees may contribute more than 2.0%, and employers may locally negotiate higher matches than the required 1.0%, not to exceed a total match of 3.0% (for an employee contribution of 6.0%). However, any additional employer match beyond 1.0% is at the discretion of the employer, and must be decided annually. An employer may negotiate matches for nonhybrid employee contributions.

-- Third-Party Contracted Employees

Currently, members who retired before July 1, 2010, may return to work and avoid the earnings limitations in statute (roughly one-third of final average compensation) if they return to work as contractual employees, using a third-party employer. The employer also does not have to pay contributions to MPSERS for these employees.

Public Act 75 closed this avoidance of the earnings limitation cap. Members retiring on or after July 1, 2010, who draw a pension and return to work directly for a MPSERS reporting unit will remain subject to the current earnings limitation cap, meaning they may draw a pension and retiree health care and still earn a working salary equal to roughly one-third of their FAC. However, if a retiree working directly for a reporting unit exceeds that earnings cap, then the retiree will forfeit pension and retiree health care, until he or she ceases employment. Also, new retirees who return to work indirectly (either via a third party or as an independent contractor) will have their pension and retiree health care suspended (i.e., not provided) for the period of time they are performing core services.

Fiscal Impact

If found to be legal, requiring all employees to pay 3.0% of salary toward retirement health care will create savings for employers, because these employee contributions will be used to help pay for current-year retiree health care costs, and will reduce the employer contribution rate fcrom what it otherwise would have been. The estimated employee contributions total $300.0 million in the first year, and $3.5 billion over 10 years.

The revised hybrid plan is estimated to save $1.2 million in the first year, and $129.4 million over 10 years.

Local savings in the initial years will not be affected via a lower MPSERS contribution rate, because the pension system will have to pay for the enhanced multiplier and the early out. In fact, the contribution rate may increase in the short term, above what it otherwise would have been, and certainly will increase if resolution of the lawsuit determines that employee contributions may not be collected. Any local savings in the initial years will be driven entirely by local decisions: employees retiring (or not) and the wage and replacement decisions made by the employer. Once the costs of the enhanced multiplier and early out have been paid for (by FY 2016-17), the MPSERS contribution rate should be around three percentage points lower than what otherwise would have occurred (without these changes in law), but only if the employee contributions are allowed. This is because of the increased employee contributions to the system, and the introduction of the hybrid plan for new employees, both of which lower the cost to employers, via the MPSERS contribution rate.